

ARTICLES

Status Quo Maintained: Supreme Court of Delaware Precludes Stockholder Derivative Claims

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In a highly anticipated decision in the Wal-Mart derivative litigation—*In re Wal-Mart Stores, Inc. Delaware Derivative Litigation*, No. 7455-CB, 2018 WL 547768 (Del. Jan. 25, 2018)—the Supreme Court of Delaware declined to adopt the Court of Chancery’s recommendation to limit the preclusive effect of decisions by out-of-state courts on demand futility. Instead, the court affirmed the chancellor’s original decision dismissing the Delaware stockholders’ derivative claims as precluded by an earlier dismissal in a parallel derivative action in Arkansas federal court. In doing so, the Delaware court maintained the status quo and assuaged the uncertainty that followed the Chancery Court’s aberrant proposal that a prior derivative suit should not bind the corporation or other stockholders in another derivative action unless (1) the board of directors declined to oppose the suit or (2) the prior suit survived a motion to dismiss under Rule 23.1 asserting failure to make a pre-suit demand.

The Backdrop

This decision arose out of a series of consolidated derivative actions filed in Arkansas federal court and Delaware Chancery Court based on an alleged bribery scheme involving Wal-Mart’s Mexico subsidiary. The Arkansas plaintiffs based their case solely on publicly available documents. The Delaware plaintiffs, by contrast, pursued a request under section 220 to obtain access to Wal-Mart’s books and records at the instruction of the Delaware Chancery Court. An Arkansas federal district court dismissed the stockholders’ claims under Rule 23.1 for failure to plead demand futility. See *In re Wal-Mart Stores, Inc. S’holder Deriv. Litig.*, No. 4:12-cv-4041, 2015 WL 1470184 (W.D. Ark. Mar. 31, 2015), amended by 2015 WL 13375767 (W.D. Ark. Apr. 3, 2015), *aff’d*, 829 F.3d 983 (8th Cir. 2016). The Delaware plaintiffs filed an amended complaint after the books and records actions concluded, which was not long after the demand futility decision in the Arkansas proceeding. The Delaware defendants then moved to dismiss the Delaware action on the grounds that the Arkansas judgment precluded the Delaware plaintiffs from pleading demand futility. The Chancery Court agreed, dismissing the case on issue preclusion grounds. See *In re Wal-Mart Stores, Inc. Del. Deriv. Litig.*, No. 7455-CB, 2016 WL 2908344 (Del. Ch. May 13, 2016). On appeal, the Delaware Supreme Court remanded the case to the Chancery Court specifically to consider the Delaware plaintiffs’ argument that the application of issue preclusion violated their due process implications of dismissal citing *Smith v. Bayer Corp.*, 564 U.S. 299 (2011).

Chancellor’s Proposed New Rule on Remand

In his supplemental opinion, the chancellor changed his prior ruling and recommended that the court adopt the rule proposed in *In re EZCORP, Inc. Consulting Agreement Derivative Litigation*, 130 A.3d 934 (Del. Ch. 2016). The chancellor acknowledged the “present state of the law,” under which “the [Delaware] plaintiffs’ Due Process rights were not violated.” Nonetheless, the chancellor proposed that the existence of this precedent “does not mean that a better approach is not worthy of consideration” and advocated for a new rule that “a judgment in a derivative action cannot bind a corporation or other stockholders until the suit has survived a Rule 23.1 motion to dismiss” or the board of directors declines to oppose the suit. The chancellor asserted that his recommended rule was supported by “(1) the similarities between class actions and derivative actions, (2) some of the realities of derivative litigation, and (3) public policy considerations.” The chancellor reasoned that his proposed rule would “better safeguard the due process rights of stockholder plaintiffs and should go a long way to

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addressing fast-filer problems currently inherent in multi-forum derivative litigation.” See *In re Wal-Mart Stores, Inc. Del. Deriv. Litig.*, 167 A.3d 513 (Del. Ch. 2017).

The Delaware Supreme Court’s Decision

The Delaware Supreme Court rejected the chancellor’s recommendation, aligning with both Delaware and federal precedent holding that preclusive effect may be given to other courts’ decisions on demand futility without running afoul of the Due Process Clause. Ultimately, the court recognized that Delaware’s “interest in governing the internal affairs of Delaware corporations ‘must yield to the stronger national interests that all state and federal courts have in respecting each other’s judgments.’” (quoting *Pyott v. La. Mun. Police Emps.’ Ret. Sys. (Pyott II)*, 74 A.3d 612, 616 (Del. 2014)).

The court found privity between the Arkansas plaintiffs and the Delaware plaintiffs because “[t]he corporation is always the sole owner of the claims.” Accordingly, the derivative plaintiffs in both cases “share an identity of interest in seeking to prosecute claims by and in the right of the same real party in interest—i.e., as representatives of—the corporation.” The court also specifically rejected the plaintiffs’ attempt to analogize derivative actions to class actions to find that the “right of stockholders to try to sue derivatively cannot be extinguished by a foreign judgment if no representative authority was conferred.” Under the plaintiffs’ approach, “representative authority [would be] conferred only after the derivative complaint survives a motion to dismiss for failure to plead demand futility.” The court alleviated any due process concerns by finding that both sets of plaintiffs were warned that a decision in the Arkansas proceeding would have a preclusive effect. And while the Arkansas plaintiffs’ decision to forgo a demand for books and records “might have been a tactical error,” it “did not rise to the level of constitutional inadequacy.”

Takeaways

From a policy perspective, the Delaware Supreme Court correctly rejected the plaintiffs’ attempt to analogize derivative actions to class actions. While class actions and derivative suits are both representative actions, they are substantively and procedurally different. Unlike a class action in which putative class members are absent and may be unaware of the case, the corporation is a necessary party to a derivative suit. This difference is significant. The fundamental policy behind demand futility recognizes that a ruling on this issue adjudicates the corporation’s rights, not just the rights of the individual shareholder plaintiffs. In addition, the procedural adequacy requirements for the two types of actions are distinctly different. Class actions require the court to determine the proposed representatives’ adequacy before certifying a class; whereas a Rule 23.1 demand futility motion focuses on whether the board can impartially consider a pre-suit demand. Rule 23.1 does not require a plaintiff to demonstrate adequacy, providing only that the “action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association.” These fundamental differences make a due process analogy between class actions and derivative suits dubious.

This decision reminds plaintiffs of two important strategic considerations: (1) Consider using all available tools, including books and records requests, to substantiate the allegations before filing, and (2) consider intervening in parallel litigation to protect your rights if you lose the race to the courthouse. For defendants, this case strengthens the availability of collateral estoppel and issue preclusion arguments in derivative stockholder actions where demand futility has already been litigated.

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